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TREASURY FOR OASIA AND IRS
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TAGS: EFIN EINV ECON ETRD PGOV MY
SUBJECT: MALAYSIAN GROWTH DECLINING DESPITE IMPLEMENTATION OF
SUPPORTIVE POLICY MEASURES

¶1. (SBU) SUMMARY: Malaysian government and private sector analysts expressed pessimism about the performance of the Malaysian economy in 2009 during meetings with visiting Treasury Attache Susan Baker and Econcouns. Although banks are well capitalized, a sharp decline in demand for Malaysia's manufactured exports and a sharper decline in the price of its export commodities are taking a toll on growth. Moreover, the government's RM 7 billion (USD 2 billion) fiscal stimulus package is viewed as unlikely to reverse the downward trend. With 40 percent of federal revenues dependent on Petronas, the national oil company, low oil prices coupled with declining production could force Malaysia's government to address its ballooning fiscal deficit in 2010. Ministry of Finance officials report that a goods and services tax (value-added tax) is "ready" to address this revenue shortfall; however, the political will to implement it is lacking. One private banker predicted that Bank Negara would cut interest rates by another 50 basis points during the first quarter of 2009 to cushion the economic downturn, but officials at Bank Negara warned that there were limits to what monetary and fiscal stimulus could do to address Malaysia's longer term structural problems. Bank Negara dismissed the idea that it used currency policy inappropriately. End summary.

¶2. (SBU) COMMENT: Malaysia is reaching the limit of what its own policies can do to support the economy in the short run: in monetary policy, rates are already low in absolute terms and negative in real terms, and in fiscal policy, much more spending risks a downgrade of their sovereign credit ratings. More and more, the GoM must be squaring up to reality that they need major structural reforms in several areas to end the system of racial preferences, strengthen the tax base, improve the education system and spur the private (rather than public) sector investment that would improve the economy's long term growth potential. End comment.

PROSPECTS FOR THE MALAYSIAN ECONOMY

¶3. (SBU) Bank Negara's Director of Monetary Assessment and Strategy Dr. Sukhdave Singh (protect) told Baker and Econcouns he was privately not upbeat about the prospects for the Malaysian economy: exports were down, commodity prices were way down, and manufacturing companies were looking at layoffs, he said. He hoped employers would cut wages or give time off first because consumers would be more confident and ready to spend if they remained employed. (Comment: Considering Malaysia's relatively high consumer

indebtedness levels, a sharp rise in unemployment could have serious negative ramifications for many banks. End Comment)

¶4. (SBU) Sukhdave lamented that Malaysia's capacity to deal with the global crisis was limited. While Malaysian banks were well capitalized and in good shape, interest rates had been low for some time, and now there was very little room to lower them further in an effort to stimulate the economy. He hoped the RM 7 billion fiscal stimulus plan would halt the downward spiral but said it would take time before corporate balance sheets recovered. Meanwhile, consumers were over their heads in mortgages, manufacturing was experiencing negative growth, and demand for loans from small & medium-sized enterprises was down. Auto sales were holding up but it was only a matter of time before they would be hit as well. He predicted that 2009 would be a bad year for Malaysia and across the region. Analysts were no longer pointing to a recovery in the second half of 2009; rather, they were looking to 2010 -- even to the second half of 2010.

¶5. (SBU) Malaysia would need to look at the global competitiveness of its economy, focusing on longer-term solutions, Sukhdave said. Savings rates remained high because Malaysia had an insufficient social safety net and because many Malaysians had lost faith in the country's educational system. People saved for years to send their children to study overseas. Transportation was another issue that needed to be addressed. As a result, people spent a great deal to live closer to work; if the transportation infrastructure were better, this would not be necessary. Malaysia needed to liberalize its economy and provide the right incentives to encourage investment. Sukhdave hoped the pressure from the economic downturn would help politicians to realize the importance of enacting longer-term structural economic reforms.

¶6. (SBU) He said the current downward pressure on the ringgit was a manifestation of a widespread "flight to safety" which would unwind as soon as the global economy began to show signs of recovery. Malaysia, he added, was not trying to depreciate its way out of the economic crisis. He said the ringgit was widely expected to appreciate and had experienced huge portfolio flows during the first quarter of 2008. Since then, the trend had reversed.

¶7. (SBU) Sukhdave asserted that, as an open trading nation, Malaysia needed to maintain a high level of foreign exchange reserves in its current account as a safety buffer. He divided the current account into two parts: a more reliable "core" amount derived from trade-based transactions and a "short-term" amount derived from portfolio flows, which could not be counted as part of a safety buffer because speculators were likely to pull these types of funds out of the country at the first sign of a downturn. Bank Negara tracked where transactions came from and where they were going - whether for foreign direct investment, for the stock market, or elsewhere, he said. Bank Negara intervened to mitigate extreme volatility related to short-term flows, which sometimes amounted to billions of ringgit in a month only to reverse the following month. Sukhdave insisted that Bank Negara's interventions touched upon neither the "core" current account funds nor the long-term fundamentals of the Malaysian economy. Within Bank Negara, they did not discuss exchange rates as a tool to increase the competitiveness of Malayia's exports, noting that in the current downturn in global demand, such efforts would, in any case, be useless.

MALAYSIA'S STIMULUS PLAN

¶8. (SBU) Like Sukhdave, Datuk Puan Latifah, Deputy Secretary General for Policy at the Ministry of Finance, acknowledged to Baker and Econcouns that reduced exports would deal a painful blow to the Malaysian economy going forward, but saw that as the local economy's "only problem."

¶9. (SBU) Latifah expressed confidence in the positive effects of Malaysia's economic stimulus package, which her office had drafted. The package would focus on infrastructure, training, and boosting domestic demand. The plan includes RM 1.5 billion (USD 428 million) to establish an investment fund to attract private investment, RM

1.2 billion (USD 343 million) for low and medium cost housing, and money for public transportation, roads, schools, hospitals, police stations and quarters, broadband, skills training, business premises for SMEs, education, and maintenance projects.

¶10. (SBU) Policy initiatives in the fiscal stimulus plan include a promise to "re-prioritize" government projects, develop government-owned land (much of which has been occupied by low-income "squatters" since at least the 1950s), allow employees to reduce mandatory retirement savings, and order shopping malls and hypermarkets to extend their operating hours. Import duties on cement have been abolished; duties on iron, steel and other construction materials have been reduced.

OIL REVENUE DECLINING BUT VAT TAX READY TO GO

¶11. (SBU) Latifah acknowledged that the GOM received approximately 40 percent of its federal revenue from Petronas, the national oil company, and that Malaysia was projected to become a net importer of oil over the next several years. In addition, the 2009 budget was developed based on an assumed average oil price of $125 per barrel for 2008. (Note: Petronas' 2008 profits determine their 2009 contribution to federal coffers. End note.) Therefore, the 2009 fiscal deficit would be larger than projected due to the unforeseen plummet from a high oil price of $147 to less than $47 per barrel. The average price of oil from January through November 2008 remained above $100, she said, so fiscal impacts in 2009 would be limited. However, if oil prices remain low in 2009, the GOM would face a significant reduction in its 2010 revenue.

¶12. (SBU) A Goods and Services Tax (GST, a value-added tax) was ready to go, Latifah explained, to deal with this impending problem. The plans were complete, simulations had been run - only the political will to implement it was lacking. She pointed out that

the middle of a global economic crisis was not an ideal time to implement a new tax, but she did not rule out the possibility of rolling it out in 2010.

BANKERS' OUTLOOK GLUM

¶13. (SBU) Suhaimi Ilas, Vice President & Chief Economist for Equity Markets at Aseambankers Malaysia Berhad, said Malaysia was "feeling the heat" of the global economic slowdown. His forecast for 2009 growth is 2.5 percent, compared to the government official forecast of 3.5 percent. Manufacturers were shortening working hours and mandating unpaid leave over Christmas and in some cases until the second week of January. Chinese New Year holidays would further reduce January-February manufacturing figures. The Federation of Malaysian Manufacturers was warning of a contraction in 2009, particularly in the electrical and electronics industry.

¶14. (SBU) Suhaimi said Bank Negara was likely to cut interest rates by another 50 basis points in the first quarter, but that the RM 7 billion stimulus plan (worth an estimate 1 percent of GDP) was insufficient to make much of an impact on the economy as a whole. He expressed concern about the lack of transparency surrounding the large share of the stimulus program being channeled into the government-owned asset manager Value Cap. Finally, he noted that none of the fiscal plans so far had done anything to address Malaysia's underlying problem of a low share of private investment. He did not expect that a GST would be implemented before 2011. Even if the economy revived in 2010, the GOM would need to inform businesses in advance of implementing a new tax.

¶15. (SBU) He predicted loan growth to slow to low single digit growth 2009, with banks cutting more on consumer lending. He had not seen a shortage of trade financing or other business lending. He said low-income Malaysians tended to be highly indebted, often qualifying for loans based on overtime pay which was drying up. Suhaimi noted that Malaysia's current account balance would fall, due to a sharp fall in exports and weaker remittances from overseas workers (for example, from financial sector workers in Singapore.) However, he expected imports would drop dramatically as well, since 70-75 percent of Malaysian imports were intermediate goods

reprocessed into exports. He did not think that the recent weakening in the ringgit was due to current account performance, but rather reflected the fact that real (inflation-adjusted) interest rates were sharply negative.

¶16. (SBU) In a subsequent meeting with Baker and Econoff, Stephen Hagger (protect), Managing Director for Asian Equities at Credit Suisse, agreed that the outlook for Malaysia was grim. He expressed faint hope but little expectation that the current economic pressures would lead to economic reforms. He said Deputy Prime Minister Najib had asked him in a recent meeting what Malaysia's top economic priorities should be; Hagger had responded that the racial preference policies under the New Economic Policy (NEP) needed to be sunsetted and Malaysia needed to improve its educational system. He said that there was a keen understanding among policymakers of the need to reform; however, vested interests made reform difficult.

¶17. (SBU) Ambank corporate finance officials also noted that financial markets essentially had shut down. There were no new IPOs in the pipeline. Since the government attempted to impose a windfall profit tax on electricity companies (reftel), bond issuances, including Islamic bond issuances, had disappeared. Interest in private equity deals also had dried up. Only a few companies, such as electricity producer YTL and resorts company Genting, were expanding investments and doing deals, and these were generally funded from resources already on hand at those companies.

GOVERNMENT MUST LOOSEN ITS GRIP, SAYS OFFICIAL

¶18. (SBU) Dr. Noor Azlan Ghazali (protect), Director of the Malaysian Development Institute within the Economic Planning Unit, which is part of the Prime Minister's Department, told Baker and Econoff that if Malaysia wanted to become a developed nation by 2020 it would have to "loosen the grip of government control." The GOM had a "long experience of controlling" the economy, Noor said, and

liberalization would have to come in stages as market infrastructures were developed. Noor highlighted Malaysia's lack of price flexibility as evidence that the market was not working properly. Noor felt strongly that Malaysia needed an anti-trust law to promote competition, which would aid in price flexibility as well.

¶19. (U) This cable has been cleared by Susan Baker, Treasury Attache, Singapore.